

Independent Auditors' Report

**Mayer Hoffman McCann P.C.**

An Independent CPA Firm

Conrad Government Services Division

2301 Dupont Drive, Suite 200

Irvine, California 92612

949-474-2020 ph

949-263-5520 fx

www.mhm-pc.com

To the Honorable City Council and Board of Public Utilities
City of Riverside
Riverside, California

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying financial statements of the City of Riverside, California, Water Utility, an enterprise fund of the City, as of and for the year ended June 30, 2006 as listed in the table of contents. These financial statements are the responsibility of the City of Riverside Water Utility's management. Our responsibility is to express an opinion on these financial statements based on our audits. The prior year summarized comparative financial information has been derived from the City of Riverside, California, Water Utility's 2005 financial statements which were audited by McGladrey and Pullen, LLP, and whose report dated September 30, 2005 expressed unqualified opinions on the financial statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, the financial statements of the City of Riverside, California, Water Utility are intended to present the financial position and the changes in financial position and cash flows for the City of Riverside, California, Water Utility, a fund of the City, and do not purport to, and do not, present fairly the financial position of the City of Riverside, California, and the changes in its financial position and its cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the City of Riverside, California, Water Utility, as of June 30, 2006 and the changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis, as listed in the table of contents, is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Independent Auditors' Report



To the Honorable City Council and Board of Public Utilities
City of Riverside

Our audits were conducted for the purpose of forming an opinion on the financial statements that comprise the City of Riverside, California, Water Utility's basic financial statements. The supplementary information entitled Water Key Historical Data, as listed in the table of contents, is presented for the purpose of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements and, accordingly, we express no opinion on it.

In accordance with Government Auditing Standards, we have also issued our report dated September 30, 2006 on our consideration of the City of Riverside's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

Mayer Hoffman Melnick P.C.

Irvine, California
September 30, 2006

Management's Discussion and Analysis

As management of Riverside Public Utilities (a department of the City of Riverside), we offer the readers of Riverside's Water Utility financial statements, an enterprise fund of the City, this narrative overview and analysis of the financial activities of the Water Utility (Utility) for the fiscal years ended June 30, 2006 and 2005. We encourage readers to consider the information presented here in conjunction with additional information furnished in our financial statements, which begin on page 45 of this report. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

FINANCIAL HIGHLIGHTS

The assets of the Water Utility exceeded its liabilities (equity) at the close of fiscal years 2006 and 2005 by \$228,880 and \$199,483, respectively. Of this amount, \$35,344 and \$15,870, respectively, may be used to meet the Utility's ongoing obligations to creditors and customers.

The Utility's total equity as of June 30, 2006 and 2005, respectively, increased by \$29,397 and \$5,141 from fiscal years ended June 30, 2005 and 2004, respectively.

As of June 30, 2006 and 2005, unrestricted equity represented over 103% and 48% of annual operating expenses, respectively.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis are intended to serve as an introduction to the City of Riverside Water Utility financial statements. The Water Utility is a department of the City of Riverside, and its activities are recorded in a separate enterprise fund. These financial statements include only the activities for the City of Riverside Water Utility and provide comparative information for the last two fiscal years. Information on city-wide financial results is available in the City of Riverside's "Comprehensive Annual Financial Report."

The City of Riverside Water Utility's financial statements comprise two components: 1) financial statements, and 2) notes to the financial

statements. In addition, this report also contains other supplementary information to provide the reader additional information about the Water Utility, including historical sales and other relevant data.

Included as part of the financial statements are three separate statements.

The **Balance Sheets** present information on assets and liabilities, with the difference between the two reported as equity. Over time, increases or decreases in equity may serve as a useful indicator of whether the financial condition of the utility is improving or deteriorating.

The **Statements of Revenues, Expenses and Changes in Equity** present information showing how the Utility's equity changed during the most recent two fiscal years. Results of operations are reported as underlying events occur, regardless of the timing of cash flows. Thus, revenues and expenses are reported in these statements for some items that will result in cash flows in future fiscal periods, i.e. accounts payable and accounts receivable. This is called the accrual basis of accounting and is more fully described in the accompanying Notes to the Financial Statements.

The **Statements of Cash Flows** present the cash flow changes occurring during the last two fiscal years in highly liquid cash and cash equivalents, including certain restricted assets.

The **Notes to the Financial Statements** provide additional information that is essential to a full understanding of the data provided in the Water Utility's financial statements. The notes to the financial statements can be found on pages 49 to 57 of this report.

Management's Discussion and Analysis

UTILITY FINANCIAL ANALYSIS

As noted earlier, equity (also called net assets) may serve over time as a useful indicator of the fund's financial position. In the case of Riverside's Water Utility, assets exceeded liabilities by \$228,880 and \$199,483 at the close of the fiscal years 2006 and 2005, respectively.

The Water Utility's overall equity increased by \$29,397 and \$5,141 during fiscal years 2006 and 2005, respectively, primarily due to capital contributions from developers and other parties totaling \$16,511 and \$11,826, respectively, and sale of excess water property totaling \$15,400 and \$600, respectively, offset by contributions to the general fund of \$3,539 and \$3,487, respectively. The prior fiscal year is further reduced by a special item write off of \$3,014, discussed more fully in Note 7 on Page 57 of this report.

The largest portion of the Water Utility's equity (79% and 88% as of June 30, 2006 and 2005, respectively) reflects its investment in capital assets, such as treatment, pumping, source of supply, transmission and distribution facilities, less any related outstanding debt used to acquire those assets. The Water Utility uses these capital assets to provide services to customers; consequently, these assets are not available for future spending. Resources needed to repay the outstanding debt shown on the balance sheet must come from other sources such as operations, since the capital assets themselves cannot be used to liquidate these long-term liabilities.

The Utility's net assets invested in capital assets, net of related debt as of June 30, 2006, and 2005 was \$180,708 and \$175,041, respectively, an increase of \$5,667 (3.2%) and \$7,716 (4.6%), from the respective prior fiscal year. Significant projects during the corresponding fiscal years included \$10,700 and \$4,500 for the pipeline replacement program, \$700 and \$1,700 to relocate water facilities for the State of California funded Caltrans I-215/60/91 freeway interchange project, and \$5,300 and \$5,200 in system expansion and improvements. In addition,

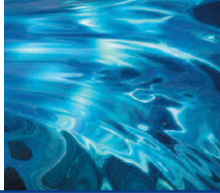
during fiscal year 2005, \$4,600 was spent to complete rehabilitation of the Riverside Canal to facilitate future water deliveries.

The Unrestricted portion of the Utility's net assets (15% and 8% for fiscal years ended June 30, 2006 and 2005, respectively) may be used to meet the Utility's ongoing obligations to creditors and customers.

An additional portion of the Water Utility's equity (6% and 4%, respectively as of June 30, 2006 and 2005) represents resources that are subject to internal and external restrictions on how they may be used. These are reserved for items such as debt repayment, and funds collected for the Water Conservation and Reclamation programs.

RIVERSIDE'S WATER UTILITY'S CONDENSED STATEMENTS OF EQUITY (NET ASSETS)

	2006	2005	2004
Current and other assets	\$ 89,399	\$ 37,701	\$ 40,754
Capital assets	254,425	241,699	230,912
Total assets	343,824	279,400	271,666
Long-term debt outstanding	97,548	63,684	66,593
Other liabilities	17,396	16,233	10,731
Total liabilities	114,944	79,917	77,324
Equity (net assets)			
Invested in capital assets, net of related debt	180,708	175,041	167,325
Restricted	12,828	8,572	8,431
Unrestricted	35,344	15,870	18,586
Total equity (net assets)	\$ 228,880	\$ 199,483	\$ 194,342



Management's Discussion and Analysis

As of June 30, 2006

ASSETS

Total assets for the two most recent fiscal years were \$343,824 and \$279,400, respectively. The \$64,424 (23.1%) increase in total assets is due to a \$12,726 increase in net capital assets (Utility plant), primarily relating to improvements to the Water Utility's distribution system, and a \$51,698 increase in current and other assets. The \$51,698 increase is comprised of \$28,900 in restricted cash and investments (primarily due to 34,400 in new bond proceeds offset by use of bond proceeds for construction projects), \$2,094 increase in accounts receivable, and \$17,854 in cash from operations, primarily relating to sales of excess of water property.

LIABILITIES

Total liabilities as of June 30, 2006 and 2005 were \$114,944 and \$79,917, respectively, an increase of \$35,027 (43.8%). Long-term obligations increased by \$33,864 primarily due to \$61,125 Water Refunding/Revenue bond issue, offset by a \$26,598 deposit into a refunding escrow account and \$3,912 of principal payments. Overall, other current liabilities are consistent with prior year.

EQUITY (NET ASSETS)

Total Water fund equity for the fiscal year ended June 30, 2006 and 2005 was \$228,880 and \$199,483, respectively, an increase of \$29,397 (14.7%) during the fiscal year. The restricted portion increased by \$4,256, due to an increase in the required debt service reserve as a result of the \$61,125 bond issue. The Unrestricted portion increased by \$19,474 primarily attributable to results of operations in the current fiscal year. The portion of equity invested in capital assets, net of related debt, increased by \$5,667 due to the amount of capital assets constructed or purchased that are not bond financed.

As of June 30, 2005

ASSETS

Total assets as of June 30, 2005 and 2004, were \$279,400 and \$271,666, respectively. The \$7,734 (2.8%) increase in total assets is due to a \$10,787 increase in net capital assets (Utility plant), primarily relating to improvements to the Water Utility's distribution system, offset by a \$3,053 decrease in current and other assets. The \$3,053 decrease is comprised of a \$5,890 increase in deferred pension costs, offset by decreases of \$5,749 in restricted cash and investments (primarily use of bond proceeds for construction projects), \$1,701 in accounts receivable, and \$1,391 in cash from operations.

LIABILITIES

Total liabilities as of June 30, 2005 and 2004 were \$79,917 and \$77,324, respectively, an increase of \$2,593 (3.4%). Although long-term obligations decreased by \$2,909 primarily due to current year principal payments, this was offset by an increase of \$5,502 in other liabilities, primarily representing the Water Utility's portion of the City's issuance of pension obligation bonds. Overall, current liabilities are consistent with prior year.

EQUITY (NET ASSETS)

Total Water fund equity for the fiscal year ended June 30, 2005 and 2004 was \$199,483 and \$194,342, respectively, an increase of \$5,141 (2.6%) during the fiscal year. The restricted portion increased by \$141, primarily due to the unspent Water Conservation and Reclamation funds. The Unrestricted portion decreased by \$2,716 primarily attributable to results of operations in the current fiscal year. The portion of equity invested in capital assets, net of related debt, increased by \$7,716 due to the amount of capital assets constructed or purchased that are not bond financed.

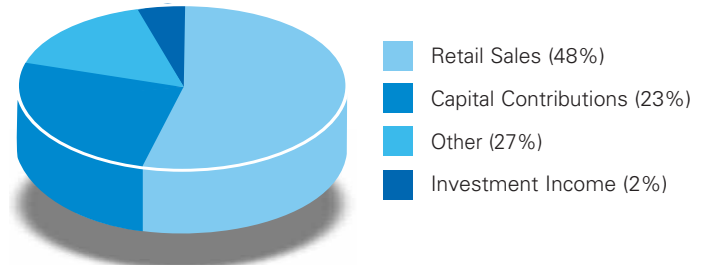
Management's Discussion and Analysis

RIVERSIDE'S WATER UTILITY'S CONDENSED STATEMENTS OF CHANGES IN EQUITY (NET ASSETS)

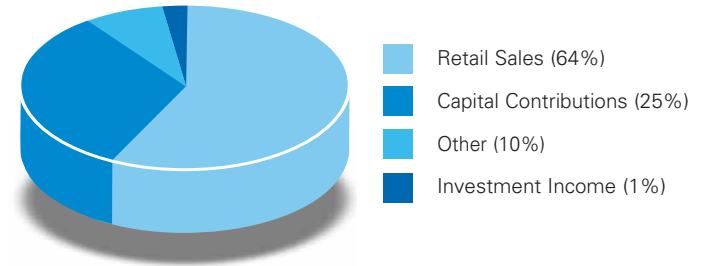
	2006	2005	2004
Revenues:			
Retail sales, net	\$ 34,301	\$ 30,754	\$ 30,363
Other revenues	19,123	4,769	2,881
Investment income	1,773	582	664
Wholesale sales	151	142	149
Conservation and reclamation	434	155	0
Capital contributions	16,511	11,826	15,494
Total revenues	72,293	48,228	49,551
Expenses:			
Operations and maintenance	21,286	20,105	17,432
Purchased energy	3,910	3,822	3,724
Purchased water	1,832	2,509	2,481
Depreciation	7,142	6,314	6,273
Conservation and reclamation	228	24	0
Interest and fiscal charges	4,959	3,812	3,881
Total expenses	39,357	36,586	33,791
Transfers to the City's general fund	(3,539)	(3,487)	(3,163)
Special Item	0	(3,014)	0
Changes in Equity	29,397	5,141	12,597
Equity, July 1	199,483	194,342	181,745
Equity, June 30	\$ 228,880	\$ 199,483	\$ 194,342

REVENUES BY SOURCES – WATER UTILITY

June 30, 2006



June 30, 2005



Year ended June 30, 2006

Total revenues for the two most recent fiscal years were \$72,293 as compared to \$48,228, a increase of \$24,065 (49.9%).

Retail sales (residential, commercial, industrial, and other sales), net of reserve/recovery were \$34,301 and \$30,754 for years ended June 30, 2006 and 2005, respectively, and continue to be the primary revenue source for the Water Utility, making up 47.4% and 63.8% of total revenues in the respective fiscal years. Retail sales, net of reserve/recovery increased \$3,547 (11.5%) from the prior year due to a 8.5% rate increase that became effective June 1, 2005 and a 3.6% increase in consumption over prior year.

Other revenues of \$19,123 and \$4,769 at June 30, 2006 and 2005, respectively, increased by \$14,354 (301%) primarily due to \$15,384 received in the current year for sales of surplus property.

Capital contributions during fiscal years 2006 and 2005 were \$16,511 and \$11,826, respectively, an

Management's Discussion and Analysis

increase of \$4,685 (39.6%). The increase reflects an increased level of construction projects funded by others and back up facility charges.

Total revenues collected for the Conservation and Reclamation Program were \$434 and \$155, respectively, an increase of \$279 (180%), implemented as part of the current three year rate plan in 2005 (see discussion under "Economic Factors and Rates" on page 43 and 44 of this report).

Year ended June 30, 2005

Total revenues for the year ended June 30, 2005 were \$48,228 as compared to \$49,551 in the prior fiscal year, a decrease of \$1,323 (2.7%).

Retail sales (residential, commercial, industrial, and other sales), net of reserve/recovery were \$30,754 and \$30,363 for years ended June 30, 2005 and 2004, respectively, and continue to be the primary revenue source for the Water Utility, making up 63.8% and 61.3% of total revenues in the respective fiscal years. Retail sales, net of reserve/recovery increased \$391 (1.3%) from the prior year due to a 8.5% rate increase that became effective June 1, 2004, offset by 8.9% lower water consumption due to cooler and wetter weather conditions.

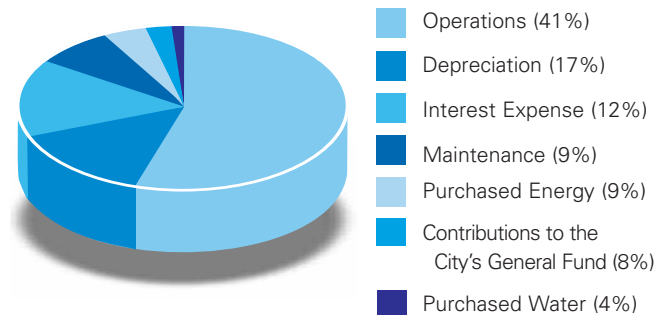
Other revenues of \$4,769 and \$2,881 at June 30, 2005 and 2004, respectively, increased by \$1,888 (65.5%) due to an additional \$1,025 of operating treatment costs reimbursed by other responsible parties for contaminating the City's water supply and \$903 received in the current year for sales of surplus property.

Capital contributions during fiscal years 2005 and 2004 were \$11,826 and \$15,494, respectively, a decrease of \$3,668 (23.7%). The decrease reflects a reduction in relocations of water facilities for the State of California funded Caltrans I-215/60/91 freeway interchange project.

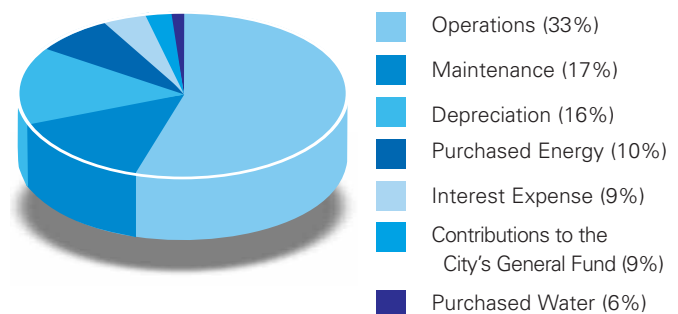
New for fiscal year ended June 30, 2005 were monies collected for Conservation and Reclamation efforts of \$155, implemented as part of the current three year rate plan (see discussion under "Economic Factors and Rates" on page 43 and 44 of this report).

EXPENSES BY SOURCES – WATER UTILITY

June 30, 2006



June 30, 2005



Year ended June 30, 2006

Total expenses for the year ended June 30, 2006 were \$39,357 as compared to \$36,586 in the prior year. The increase in total expenses of \$2,771 (7.6%) is due to higher interest expense as a result of a new revenue bond issue, higher labor costs and taxes and assessments, offset by lower purchased water costs and charges for professional services.

Operations and maintenance costs were \$21,286 and \$20,105 for fiscal years 2006 and 2005, respectively, an increase of \$1,181 (5.9%). The majority of the increase is primarily due to an increase in labor costs and taxes and assessments, offset by a decrease in professional service costs.

Management's Discussion and Analysis

Year ended June 30, 2005

Total expenses for the year ended June 30, 2005 were \$36,586 as compared to \$33,791 in the prior year. The increase in total expenses of \$2,795 (8.3%) is due to personnel cost increases in the current year and cost of living type increases in other operating categories,

Operations and maintenance costs were \$20,105 and \$17,432 for fiscal years 2005 and 2004, respectively, an increase of \$2,673 (15.3%). The majority of the increase is primarily due to a \$1,287 increase in salary costs – including overtime expenses to maintain or increase customer service levels (\$545) and related benefits (\$742), and an increase in professional services (\$736) to prepare the water master and water supply plans.

TRANSFERS

Year ended June 30, 2006

Transfers to the City's general fund are limited by Section 1204(f) of the City Charter to a maximum of 11.5% of prior year gross operating revenue. The Water Utility transferred approximately 11.5% of prior year operating revenues, or \$3,539 in the current year, compared to \$3,487 in the prior year primarily as a result of an increase in retail sales of \$391 for fiscal year 2005 over prior year levels.

Year ended June 30, 2005

Transfers to the City's general fund of \$3,487 increased by \$324, primarily as a result of the \$3,026 increase in retail sales for fiscal year 2004 over the prior year levels.

CAPITAL ASSET AND DEBT ADMINISTRATION

The Water Utility's investment in Capital Assets includes investments in source of supply, pumping, treatment, transmission and distribution facilities, and construction in progress, as well as general items such as office equipment, furniture, etc.

For descriptions of major capital assets constructed during the fiscal years 2006 and 2005, see discussion under "Utility Financial Analysis" on page 38 of this report.

CITY OF RIVERSIDE WATER UTILITY'S CAPITAL ASSETS (NET OF ACCUMULATED DEPRECIATION)

	2006	2005	2004
Source of supply	\$ 22,727	\$ 21,935	\$ 11,293
Pumping	7,918	4,714	3,238
Treatment	13,483	12,758	13,143
Transmission and distribution	190,708	173,732	160,716
General	3,066	3,352	1,489
Land	3,891	6,283	8,405
Intangible	5,969	6,269	6,269
Construction in progress	6,663	12,656	26,359
Total	<u>\$ 254,425</u>	<u>\$ 241,699</u>	<u>\$ 230,912</u>

Additional information regarding capital assets can be found in Note 3 on Page 53 of this report.

As of June 30, 2006

Capital assets, net of depreciation, for the Water Utility were \$254,425 compared to \$241,699 as of June 30, 2006 and 2005, respectively, a \$12,726 (5.3%) increase. The majority of assets capitalized in the current year were for transmission and distribution and pumping facilities. For more detailed description of assets constructed in the current fiscal year, see discussion above under "Utility Financial Analysis."

Management's Discussion and Analysis

As of June 30, 2005

Capital assets, net of depreciation, for the Water Utility were \$241,699 compared to \$230,912 as of June 30, 2005 and 2004, respectively, a \$10,787 (4.7%) increase. The majority of assets capitalized for this period were for transmission and distribution and source of supply facilities. For more detailed description of assets constructed during the fiscal year, see discussion above under "Utility Financial Analysis."

CITY OF RIVERSIDE WATER UTILITY'S OUTSTANDING DEBT (REVENUE BONDS AND CONTRACTS PAYABLE)

At the end of fiscal years ended June 30, 2006 and 2005 the City of Riverside's Water Utility had long-term debt outstanding of \$97,548 and \$63,684, respectively. This debt is backed by the revenues of the Utility (revenue bonds).

	2006	2005	2004
Revenue bonds	\$ 103,815	\$ 71,015	\$ 75,060
Contracts payable	979	1,015	1,039
Less:			
Unamortized bond discount/capital appreciation	(2,796)	(4,121)	(5,311)
Less: Current portion	(4,450)	(4,225)	(4,195)
Total	<u>\$ 97,548</u>	<u>\$ 63,684</u>	<u>\$ 66,593</u>

The Water Utility's bond indentures require the Utility to maintain a minimum debt service coverage ratio, as defined by the bond covenants, of 1.25. The Water Utility's debt service coverage ratio was 5.11 at June 30, 2006 and 2.85 at June 30, 2005.

As of June 30, 2006

Long-term debt of \$103,815 increased by \$32,800 (46.2%) from June 30, 2005, due to the issuance of a \$61,125 variable rate Water Refunding Revenue bond issue offset by the repayment of principal on the Water Utility's outstanding revenue bonds.

As of June 30, 2005

Long-term debt of \$71,015 decreased by \$4,045 (5.4%) from June 30, 2004, due to the repayment of principal on the Water Utility's outstanding revenue bonds.

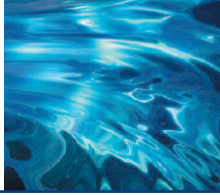
The Water Utility maintains an "AA" credit rating from Standard & Poor's and Fitch, Inc. for its revenue bonds.

Additional information on the Water Utility's long-term debt can be found in Note 4 on pages 53 to 56 of this report.

ECONOMIC FACTORS AND RATES

Although inflationary trends in the Riverside region continue to compare favorably to the national indices, the Water Utility's escalation in costs are not strictly attributable to inflation. One of the primary drivers of the increase in costs relates to the Water Utility's aging infrastructure.

To address this concern, the Board of Public Utilities, after the requisite public hearing, adopted and the City Council unanimously approved, the SAFE W.A.T.E.R. (Water Available to Everyone in Riverside) Plan. This plan implements system improvements contained in the Water Master, Water Supply and Asset Management Plans. The SAFE W.A.T.E.R. Plan is initially funded by a fifty-two percent, five-year water rate increase, consisting of a twelve percent and four-ten percent increases effective November 1, 2006, 2007, 2008, 2009, and 2010, respectively.



Management's Discussion and Analysis

In addition to inflation, management continually plans for and identifies issues or potential contingencies that could impact future rates such as reclaimed water, infrastructure needs, system growth, source of supply, ground water contamination, stricter contaminant guidelines, legislative mandates, and others. In an effort to control costs to its customers, the Utility is aggressive in pursuing outside parties and holding them financially responsible for any negative effects they may cause to Riverside's water quality.

Requests for Information

This financial report is designed to provide a general overview of the City of Riverside Water Utility's finances. Questions concerning any information provided in this report or requests for additional financial information should be addressed to the Assistant Director Finance/Customer Relations or the Utilities Assistant Chief Financial Officer, Riverside Public Utilities, 3900 Main Street, Riverside, CA 92522.

Balance Sheets



	June 30, 2006	June 30, 2005
	(in thousands)	
ASSETS		
UTILITY PLANT:		
Source of supply	\$ 32,684	\$ 31,315
Pumping	13,986	10,515
Treatment	15,449	14,313
Transmission and distribution	273,785	251,583
General	8,969	8,977
	344,873	316,703
Less accumulated depreciation	(106,971)	(100,212)
	237,902	216,491
Land	3,891	6,283
Intangible	5,969	6,269
Construction in progress	6,663	12,656
Total utility plant (Note 3)	254,425	241,699
RESTRICTED ASSETS:		
Cash and cash equivalents (Note 2)	4,424	3,943
Cash and investments at fiscal agent (Note 2)	8,046	4,457
Total restricted assets	12,470	8,400
OTHER NON-CURRENT ASSETS:		
Deferred pension costs	5,876	5,890
Deferred bond issuance/refunding costs	3,654	1,245
Advances to the City's general fund	28	48
Total other non-current assets	9,558	7,183
Total non-current assets	276,453	257,282
CURRENT ASSETS:		
<i>Unrestricted:</i>		
Cash and cash equivalents (Note 2)	33,765	15,911
Accounts receivable, less allowance for doubtful accounts 2006 \$36; 2005 \$51	4,283	3,776
Accounts receivable, other utilities and governments, less allowance for doubtful accounts 2006 \$215; 2005 \$172	3,664	2,077
Accrued interest receivable	327	217
Prepaid expenses	368	0
Total unrestricted assets	42,407	21,981
<i>Restricted assets:</i>		
Cash and investments at fiscal agent (Note 2)	24,627	5
Cash and cash equivalents (Note 2)	276	121
Conservation and Reclamation Programs receivable	61	11
Total restricted assets	24,964	137
Total current assets	67,371	22,118
Total assets	\$ 343,824	\$ 279,400

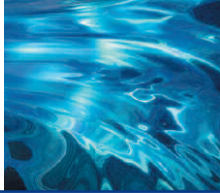
See accompanying notes to the financial statements

Balance Sheets



EQUITY AND LIABILITIES

	June 30, 2006 (in thousands)	June 30, 2005 (in thousands)
EQUITY:		
Invested in capital assets, net of related debt	\$ 180,708	\$ 175,041
Restricted for:		
Debt service (Note 5)	12,491	8,440
Conservation & Reclamation Programs	337	132
Unrestricted	35,344	15,870
Total equity	228,880	199,483
LONG-TERM OBLIGATIONS, LESS CURRENT PORTION (NOTE 4)	97,548	63,684
OTHER NON-CURRENT LIABILITIES:		
Pension obligation (Note 4)	5,823	5,890
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS:		
Accrued interest payable	325	610
Conservation & Reclamation Programs	0	1
Current portion of long-term debt (Note 4)	4,300	4,075
Total current liabilities payable from restricted assets	4,625	4,686
CURRENT LIABILITIES:		
Accounts payable	3,248	2,115
Accrued liabilities	2,150	2,027
Current portion of long-term debt (Note 4)	150	150
Customer deposits	1,400	1,365
Total current liabilities	6,948	5,657
Total liabilities	114,944	79,917
COMMITMENTS AND CONTINGENCIES (NOTES 6 AND 8)		
Total equity and liabilities	\$ 343,824	\$ 279,400



Statements of Revenues, Expenses and Changes in Equity

For the Fiscal Years
Ended June 30,
2006 2005
(in thousands)

OPERATING REVENUES:

Residential sales	\$ 22,336	\$ 20,043
Commercial sales	10,470	9,252
Other sales	1,617	1,582
Wholesale sales	151	142
Conservation & Reclamation	434	155
Other operating revenue	2,598	2,978
Total operating revenues before (reserve)/recovery	37,606	34,152
Reserve for uncollectible, net of bad debt recovery	(122)	(123)
Total operating revenues, net of (reserve)/recovery	37,484	34,029

OPERATING EXPENSES:

Operations	17,593	13,293
Maintenance	3,693	6,812
Purchased energy	3,910	3,822
Purchased water	1,832	2,509
Conservation & Reclamation Programs	228	24
Depreciation	7,142	6,314
Total operating expenses	34,398	32,774
Operating income	3,086	1,255

NON-OPERATING REVENUES (EXPENSES):

Investment income	1,773	582
Interest expense and fiscal charges	(4,959)	(3,812)
Gain on sale of capital assets	12	42
Gain on sale of land	15,384	578
Other	1,129	1,171
Total non-operating revenues (expenses)	13,339	(1,439)
Income (loss) before contributions and transfers	16,425	(184)
Capital contributions	16,511	11,826
Transfers out - contributions to the City's general fund	(3,539)	(3,487)
Total capital contributions and transfers out	12,972	8,339
Income before special item	29,397	8,155

SPECIAL ITEM:

Canal abandonment	0	(3,014)
Increase in equity	29,397	5,141

EQUITY, BEGINNING OF YEAR:

199,483	194,342
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EQUITY, END OF YEAR:

\$ 228,880	\$ 199,483
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See accompanying notes to the financial statements



Statements of Cash Flows

For the Fiscal Years
Ended June 30,
2006 2005
(in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES:

Cash received from customers and users	\$ 35,497	\$ 36,852
Cash paid to suppliers and employees	(26,476)	(27,966)
Other receipts	1,129	1,171
Canal abandonment	0	(1,147)
Net cash provided by operating activities	10,150	8,910

CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES:

Transfers out - contributions to the City's general fund	(3,539)	(3,487)
Principal paid on pension obligation bonds	(67)	0
Net cash used by non-capital financing activities	(3,606)	(3,487)

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:

Purchase of utility plant	(17,167)	(17,242)
Proceeds from the sale of utility plant	18,327	999
Principal paid on long-term debt	(3,912)	(4,069)
Interest paid on long-term debt	(4,086)	(2,548)
Proceeds from sale of revenue bonds, net of premium	61,824	0
Deposit to escrow account for advance bond refunding	(24,450)	0
Bond issuance costs	(2,940)	0
Capital contributions	10,878	9,721
Net cash provided (used) by capital and related financing activities	38,474	(13,139)

CASH FLOWS FROM INVESTING ACTIVITIES:

Reduction in advances to the City's general fund	20	24
Purchases of investment securities	(3,589)	(296)
Income from investments	1,663	543
Net cash provided (used) by investing activities	(1,906)	271
Net increase (decrease) in cash and cash equivalents	43,112	(7,445)

CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR

19,980 27,425

CASH AND CASH EQUIVALENTS, END OF YEAR

\$ 63,092 \$ 19,980

RECONCILIATION OF OPERATING INCOME

TO NET CASH PROVIDED BY OPERATING ACTIVITIES:

Operating income	\$ 3,086	\$ 1,255
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	7,142	6,314
Amortization of deferred charges-pension costs	14	0
Increase in uncollectible accounts receivable	28	16
Decrease (increase) in accounts receivable	(2,172)	1,713
Increase in prepaid expenses	(368)	0
Increase (decrease) in accounts payable	1,133	(1,248)
Increase (decrease) in accrued liabilities	123	(136)
Increase in Conservation & Reclamation Programs	0	1
Increase in customer deposits	35	971
Other receipts	1,129	1,171
Canal abandonment	0	(1,147)
Net cash provided by operating activities	\$ 10,150	\$ 8,910

SCHEDULE OF NON-CASH INVESTING, CAPITAL AND FINANCING ACTIVITIES:

Capital contributions - capital assets	5,632	2,105
Canal abandonment	0	1,867
Pension obligation	0	5,890

See accompanying notes to the financial statements

WATER

Notes to the Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Water Utility exists under, and by virtue of, the City Charter enacted in 1883. The Water Utility is responsible for the production, transmission and distribution of water for sale in the City, except for certain areas served by another water utility.

■ **Basis of Accounting** The Water Utility uses the accrual basis of accounting as required for enterprise funds with accounting principles generally accepted in the United States of America as applicable to governments. The accounting records of the Water Utility are also in conformity with the Uniform System of Accounts prescribed by the California Public Utilities Commission. The Water Utility is not subject to the regulations of the California Public Utilities Commission. The Water Utility is not required to and does not elect to implement the pronouncements of the Financial Accounting Standards Board issued after November 1989.

■ **Use of Estimates** The preparation of financial statements in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during a reporting period. Actual results could differ from those estimates.

■ **Revenue Recognition** Water Utility customers are billed monthly. Unbilled water service charges are recorded at year-end and are included in accounts receivable. Unbilled accounts receivable totaled \$2,553 at June 30, 2006, and \$2,152 at June 30, 2005.

An allowance for doubtful accounts is maintained for utility and miscellaneous accounts receivable. The balance in this account is adjusted at fiscal year-end to approximate the amount anticipated to be uncollectible.

■ **Utility Plant and Depreciation** Utility plant assets are valued at historical cost or estimated historical cost, if actual historical cost is not available. Costs include labor; materials; interest during construction; allocated indirect charges such as

engineering, supervision, construction and transportation equipment, retirement plan contributions and other fringe benefits. Contributed plant assets are valued at estimated fair value on the date contributed. The cost of relatively minor replacements is included in maintenance expense.

Depreciation is recorded over the estimated useful lives of the related assets using the straight-line method. The estimated useful lives are as follows:

Supply, pumping and treatment plant	15-50 years
Transmission and distribution plant	25-50 years
General plant and equipment	3-50 years

■ **Restricted Assets** Proceeds of revenue bonds yet to be used for capital projects, as well as certain resources set aside for debt service, are classified as restricted assets on the Balance Sheets because their use is limited by applicable bond covenants.

In June 2004, the City began collecting a surcharge for water conservation and reclamation programs. This surcharge was approved by the City Council and is being phased in over a three-year period with a 0.5%, 1.0% and 1.5% surcharge effective June 1, 2004, 2005 and 2006, respectively. The programs and services offered include conservation, education, and water use efficiency programs; programs to encourage the use of reclaimed water; research, development and demonstration programs to advance science and technology with respect to water conservation and reclamation; and water service provided to low-income customers. This surcharge is scheduled to be in effect for services rendered on or after June 1, 2004 through May 31, 2014. The activity associated with the surcharge for water conservation and reclamation programs is reflected in the accompanying financial statements on the Balance Sheets, Statements of Revenues, Expenses and Changes in Equity, and Statements of Cash Flows.

■ **Cash and Investments** In accordance with Utility policy, the Utility's cash and investments, except for cash and investments with fiscal agents, are invested in a pool managed by the Treasurer of the City. The Utility does not own specific, identifiable investments of the pool. The pooled interest earned is allocated monthly based on the month end cash balances.

Notes to the Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The City values its cash and investments in accordance with provisions of Governmental Accounting Standards Board (GASB) Statement No. 31, Accounting and Financial Reporting for Certain Investments and External Investment Pools (GASB 31), which requires governmental entities, including governmental external investment pools, to report certain investments at fair value in the Statements of Net Assets/Balance Sheets and recognize the corresponding change in the fair value of investments in the year in which the change occurred. Fair value is determined using quoted market prices.

Cash accounts of all funds are pooled for investment purposes to enhance safety and liquidity while maximizing interest earnings.

City-wide information concerning cash and investments for the year ended June 30, 2006, including authorized investments, custodial credit risk, credit and interest rate risk for debt securities and concentration of investments, carrying amount and market value of deposits and investments may be found in the notes to the City's "Comprehensive Annual Financial Report."

■ Cash and Investments at Fiscal Agents

Cash and investments maintained by fiscal agents are considered restricted by the Utility and are pledged as collateral for payment of principal and interest on outstanding bonds.

■ Bond Discounts, Capital Appreciation and Issuance Costs

Bond discounts, capital appreciation and issuance costs are deferred and amortized over the term of the bonds using the effective interest method. Bond discounts and capital appreciation are presented as a reduction of the face amount of bonds payable, whereas issuance costs are recorded as other assets. Capital appreciation is the annual increase in the value of bonds originally issued at a discounted amount. These bonds do not pay annual interest and mature at a pre-determined par value.

■ Customer Deposits The City holds customer deposits as security for the payment of utility bills. The Water Utility's portion of these deposits as of June 30,

2006 and 2005, was \$1,400 (includes \$1,032 held on behalf of La Sierra Water Company pending dissolution and distribution of remaining cash asset to shareholders, of which the City is the largest owner) and \$1,365, respectively.

■ Compensated Absences The accompanying financial statements include accruals for salaries, fringe benefits and compensated absences due employees at June 30, 2006 and 2005. The Water Utility treats compensated absences due employees as a current liability. The amount accrued for compensated absences was \$2,150 at June 30, 2006, and \$2,027 at June 30, 2005, and is included in accrued liabilities in the accompanying Balance Sheets.

Employees receive 10 to 25 vacation days per year based upon length of service. A maximum of two years vacation may be accumulated, and unused vacation is paid in cash upon separation.

Employees primarily receive one day of sick leave for each month of employment with unlimited accumulation. Upon retirement or death only, a percentage of unused sick leave is paid to certain employees or their estates in a lump sum based on longevity.

■ Insurance Programs The Water Utility participates in a self-insurance program for worker's compensation and general liability coverage that is administered by the City. The Water Utility pays an amount to the City representing an estimate of amounts to be paid for reported claims incurred and incurred but unreported claims based upon past experience, modified for current trends and information. The city maintains property insurance on most city property holdings, including Utility plant with a limit of \$100 million.

City-wide information concerning risks, insurance policy limits and deductibles and designation of general fund balance for risks for the year ended June 30, 2006, may be found in the notes to the City's "Comprehensive Annual Financial Report."

Although the ultimate amount of losses incurred through June 30, 2006, is dependent upon future developments, management believes that amounts paid to the City are

Notes to the Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

sufficient to cover such losses. Premiums paid to the City by the Water Utility were \$376 and \$614 for the years ended June 30, 2006 and 2005, respectively. Any losses above the City's reserves would be covered through increased rates charged to the Water Utility in future years.

■ **Employee Retirement Plan** The City contributes to the California Public Employees Retirement System (PERS), an agent multiple-employer public employee retirement system that acts as a common investment and administrative agency for participating public entities within the State of California.

All permanent full-time and selected part-time employees are eligible for participation in PERS. Benefits vest after five years of service and are determined by a formula that considers the employee's age, years of service and salary. Employees may retire at age 55 and receive 2.7 percent of their highest average annual salary for each year of service completed. PERS also provides death and disability benefits. These benefit provisions and all other requirements are established by state statute and City ordinance.

Employee contributions are 8.0 percent of their annual covered salary. The Water Utility is required to contribute the remaining amounts necessary to fund the benefits for its employees using the actuarial basis recommended by the PERS actuaries and actuarial consultants and adopted by the PERS Board of Administration. The employer portion of PERS funding as of June, 30 2006 and 2005, was 19.74 percent and 12.34 percent, respectively, of annual covered payroll. The Water Utility pays both the employee and employer contributions. The total Water Utility's contribution to PERS as of June 30, 2006 and 2005, was \$1,539 and \$1,537, respectively.

City-wide information concerning elements of the unfunded actuarial accrued liabilities, contributions to PERS for the fiscal year ended June 30, 2006, and recent trend information may be found in the notes to the City's "Comprehensive Annual Financial Report" for the fiscal year ended June 30, 2006.

■ **Pension Obligation Bonds** In 2005, the City issued Pension Obligation Bonds in the amount of \$60,000, of which the Water Utility's share was \$5,890 as reflected in the accompanying Balance Sheet as deferred pension costs and a corresponding long-term obligation. The deferred charge relating to the net pension asset will be amortized over 19 years in accordance with the method used by CalPERS for calculating actuarial gains and losses. The Bonds will be used to fund the unfunded actuarial accrued liability for non-safety employees and the proceeds were deposited with CalPERS. The balance in deferred pension costs as of June 30, 2006 and 2005 was \$5,876 and \$5,890, respectively. For more discussion relating to the City's issue, see the notes to the City's "Comprehensive Annual Financial Report" for the fiscal year ended June 30, 2006.

■ **Equity** The Water Utility's equity consists of its net assets (assets less liabilities) which are classified into the following three components:

- Invested in capital assets, net of related debt – this component consists of capital assets (net of accumulated depreciation) and unamortized debt expenses reduced by the outstanding balances of any bonds or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
- Restricted – this component consists of net assets on which constraints are placed as to their use. Constraints include those imposed by creditors (such as through debt covenants) contributors, or laws or regulation of other governments or constraints imposed by law through constitutional provisions or through enabling legislation.
- Unrestricted net assets – this component of net assets consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

■ **Contributions to the City's General Fund**

Pursuant to the City Charter, the Water Utility may transfer up to 11.5 percent of its prior year's gross operating revenues to the City's general fund. In fiscal years 2005-06 and 2004-05, the Water Utility transferred 11.5 percent of gross operating revenues, or \$3,539 and \$3,487, respectively.

Notes to the Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

■ **Cash and Cash Equivalents** For the Statements of Cash Flows, cash and cash equivalents include all unrestricted and restricted highly liquid investments with original purchase maturities of three months or less, and all bond construction proceeds available for capital projects. Pooled cash and investments in the City's Treasury represent monies in a cash management pool. Such accounts are similar in nature to demand

deposits, and are classified as cash equivalents for the purpose of presentation in the Statements of Cash Flows.

■ **Budgets and Budgetary Accounting** The Water Utility presents, and the City Council adopts, an annual budget. The proposed budget includes estimated expenses and forecasted revenues. The City Council adopts the Water Utility's budget in June each year via resolution.

NOTE 2. CASH AND INVESTMENTS

Cash and investments at June 30, 2006 and 2005, consist of the following (in thousands):

	June 30, 2006	June 30, 2005
	Fair Value	
Equity interest in City Treasurer's investment pool	\$ 38,465	\$ 19,975
Investments at fiscal agent	32,673	4,462
Total cash and investments	\$ 71,138	\$ 24,437

The amounts above are reflected in the accompanying financial statements as:

	June 30, 2006	June 30, 2005
Unrestricted cash and cash equivalents	\$ 33,765	\$ 15,911
Restricted assets:		
Cash and cash equivalents	4,700	4,064
Cash and investments at fiscal agent	24,627	5
Total cash and cash equivalents	63,092	19,980
Cash and investments at fiscal agent	8,046	4,457
Total cash and investments	\$ 71,138	\$ 24,437

Cash and investments as follows:

Investment Type	Remaining Maturity (in Months)				
	Total	12 Months or Less	13 to 24 Months	25 to 60 Months	More than 60 Months
Held by Fiscal Agent					
Money Market Funds	\$ 132	\$ 132	\$ 0	\$ 0	\$ 0
Federal Agency Securities	2,409	2,409	0	0	0
Investment Contracts ¹	30,132	0	0	24,609	5,523
City Treasurer investment pool ²					
Money Market Funds	4,559	4,559	0	0	0
Federal Agency Securities	27,744	8,884	4,144	14,716	0
Corp Medium Term Notes	4,394	2,670	1,724	0	0
State Investment Pool	1,768	1,768	0	0	0
Total	\$ 71,138	\$ 20,422	\$ 5,868	\$ 39,325	\$ 5,523

All cash and investments held by fiscal agent are held in AAA investments

¹ Amounts related to bond construction proceeds are invested in specific maturities but are available for construction of capital assets as funding is needed.

² Additional information on investment types and credit risk may be found in the City's "Comprehensive Annual Financial Report."

Notes to the Financial Statements



NOTE 3. UTILITY PLANT

The following is a summary of changes in utility plant during the fiscal years ended June 30, 2006 and 2005 (in thousands):

	Balance, As of 6/30/2004	Additions	Retirements/ Transfers	Balance, As of 6/30/2005	Additions	Retirements/ Transfers	Balance, As of 6/30/2006
Source of supply	\$ 20,276	\$ 11,040	(\$ 1)	\$ 31,315	\$ 1,377	(\$ 8)	\$ 32,684
Pumping	8,859	1,656	0	10,515	3,471	0	13,986
Treatment	14,306	7	0	14,313	1,136	0	15,449
Transmission and distribution	233,703	18,074	(194)	251,583	22,374	(172)	273,785
General	7,040	2,202	(265)	8,977	234	(242)	8,969
Depreciable utility plant	284,184	32,979	(460)	316,703	28,592	(422)	344,873
Less accumulated depreciation							
Source of supply	(8,983)	(398)	1	(9,380)	(587)	10	(9,957)
Pumping	(5,621)	(180)	0	(5,801)	(267)	0	(6,068)
Treatment	(1,163)	(392)	0	(1,555)	(411)	0	(1,966)
Transmission and distribution	(72,987)	(5,029)	165	(77,851)	(5,359)	133	(83,077)
General	(5,551)	(314)	240	(5,625)	(518)	240	(5,903)
Accumulated depreciation	(94,305)	(6,313)	406	(100,212)	(7,142)	383	(106,971)
Net depreciable utility plant	189,879	26,666	(54)	216,491	21,450	(39)	237,902
Land	8,405	42	(2,164)	6,283	221	(2,613)	3,891
Intangible	6,269	0	0	6,269	0	(300)	5,969
Construction in progress	26,359	19,375	(33,078)	12,656	22,831	(28,824)	6,663
Nondepreciable utility plant	41,033	19,417	(35,242)	25,208	23,052	(31,737)	16,523
Total utility plant	\$ 230,912	\$ 46,083	(\$ 35,296)	\$ 241,699	\$ 44,502	(\$ 31,776)	\$ 254,425

NOTE 4. LONG-TERM OBLIGATIONS

The following is a summary of changes in long-term obligations during the fiscal years ended June 30, 2006 and 2005 (in thousands):

	Balance, As of 6/30/2004	Additions	Reductions	Balance, As of 6/30/2005	Additions	Reductions	Balance, As of 6/30/2006	Due within one year
Revenue bonds	\$ 69,749	\$ 0	(\$ 2,855)	\$ 66,894	\$ 61,125	(\$ 27,000)	\$ 101,019	\$ 4,300
Pension obligation	0	5,890	0	5,890	0	(67)	5,823	62
Water stock acquisition rights	1,039	0	(24)	1,015	0	(36)	979	150
Total long-term obligations	\$ 70,788	\$ 5,890	(\$ 2,879)	\$ 73,799	\$ 61,125	(\$ 27,103)	\$ 107,821	\$ 4,512



Notes to the Financial Statements

NOTE 4. LONG-TERM OBLIGATIONS (CONTINUED)

Long-term debt consists of the following (in thousands):

■ Contracts Payable

Water Stock Acquisitions: Payable on demand to various water companies

Total contracts payable

■ Revenue Bonds Payable

\$69,840 1991 Water Revenue Bonds: \$25,900 serial capital appreciation bonds due in annual installments from \$3,235 to \$3,240 from October 1, 2006, to October 1, 2010; (partially advance refunded in 1998)

\$4,710 1994 FARECal Revenue Bonds: All outstanding bonds were advance refunded on September 20, 2005 with the 2005 Water Refunding/Revenue bonds

\$30,965 1998 Water Refunding/Revenue Bonds: \$15,055 serial bonds due in annual installments from \$275 to \$3,690 through October 1, 2013, interest from 4.5 percent to 5.38 percent; \$10,155 term bonds due October 1, 2018, interest at 5.0 percent; \$5,755 term bonds due October 1, 2027 were advance refunded on September 20, 2005 with 2005 Water Refunding/Revenue bonds

\$20,000 2001 Water Revenue Bonds: \$10,070 serial bonds due in annual installments from \$390 to \$585 through October 1, 2016, interest from 3.25 percent to 4.75 percent; \$4,345 term bonds due October 1, 2026 and \$5,585 term bonds due October 1, 2031 were advance refunded on September 20, 2005 with 2005 Water Refunding/Revenue bonds

\$61,125 2005 Water Refunding/Revenue Bonds: \$61,125 Auction Rate Securities due in annual installments from \$400 to \$3,950 from October 1, 2006 through October 1, 2035. Interest is variable and rate is subject to weekly repricing (rate at June 27, 2006 was 3.75 percent)

Total water revenue bonds payable

Total water revenue bonds and contracts payable

Unamortized capital appreciation

Unamortized bond discount

Total water revenue bonds and contracts payable,
net of bond discount and capital appreciation

Less current portion

Total long-term water revenue bonds and contracts payable

	June 30, 2006	June 30, 2005
	\$ 979	\$ 1,015
	979	1,015
	16,185	19,425
	0	3,425
	21,265	29,230
	5,240	18,935
	61,125	0
	103,815	71,015
	104,794	72,030
	(2,487)	(3,499)
	(309)	(622)
	101,998	67,909
	(4,450)	(4,225)
	\$ 97,548	\$ 63,684

Annual debt service requirements to maturity, as of June 30, 2006, are as follows (in thousands):

	2007	2008	2009	2010	2011	2012-2016	2017-2021	2022-2026	2027-2031	2032-2036	Total
Principal	\$ 4,450	\$ 4,505	\$ 4,525	\$ 4,565	\$ 4,615	\$25,534	\$ 10,500	\$ 13,550	\$ 15,175	\$ 17,375	\$ 104,794
Interest	3,234	3,194	3,153	3,109	3,063	12,642	8,274	6,250	3,944	1,371	48,234
Total	\$ 7,684	\$ 7,699	\$ 7,678	\$ 7,674	\$ 7,678	\$ 38,176	\$ 18,774	\$ 19,800	\$ 19,119	\$ 18,746	\$153,028

Notes to the Financial Statements

NOTE 4. LONG-TERM OBLIGATIONS
(CONTINUED)

■ **2005 Water Refunding/Revenue Bonds** On September 20, 2005, the Water Utility issued \$61,125 of Water Refunding/Revenue bonds, in the form of Auction Rate Securities, to finance capital improvement programs and refund certain existing Water revenue bonds. \$30,000 of Water revenue bonds will be used to finance the costs of certain improvements to the City's Water System as part of the Capital Improvement Program. The remaining portion was used to refund all the outstanding 1994 FARECal bonds (\$3,425), \$7,705 of the outstanding 1998, and \$13,320 of the outstanding 2001 Water revenue bond issues. The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of \$2,271. This difference is being charged to operations using a proportional method. The City completed the current refunding to reduce net aggregate debt service payments over the next 26 years by \$3,663 and to obtain an economic gain (difference between present value of the old and new debt service payments) of \$2,303. Annual principal payments ranging from \$400 to \$3,950 are due from October 1, 2006 through October 1, 2035. Assuming a variable rate of 3.2%, the all-intrue interest cost for this issue is 3.54%.

■ **Interest Rate Swaps on Revenue Bonds**

Objective: As a means to lower borrowing costs, when compared against fixed-rate bonds at the time of issuance in September 2005, the City entered into interest rate swap agreements in connection with its \$61,125 2005 Water Refunding/Revenue Bonds. The intention of the swap was to effectively change the City's variable interest rate on the bonds to a synthetic fixed rate of 3.20% for the respective Water Refunding/Revenue Bonds.

Terms: Under the swaps, the City pays the counterparty a fixed payment as noted above and receives a variable payment computed as 62.68% of the London Interbank

Offering Rate ("LIBOR") one month index plus 12 basis points. The swaps have notional amounts equal to the principal amounts stated above. Starting in fiscal year 2007, the notional value of the swaps and the principal amounts of the associated debt decline by \$400 to \$3,950 until the debt is completely retired in fiscal year 2036. The bonds' variable rate coupons are established on a weekly basis through the results of an auction process administered through an auction agent, termed Auction Rate Securities ("ARS").

The bonds and the related swap agreements for the 2005 Water Refunding Revenue Bonds mature on October 1, 2035. As of June 30, 2006 rates were as follows:

	Terms	Rates
Interest rate swap:		
Fixed payment to counterparty	Fixed	3.20000%
Variable payment from counterparty	62.68 LIBOR +12bps	(3.00065%)
Net interest rate swap payments		0.19935%
Variable-rate bond coupon payments	ARS	2.86774%
Synthetic interest rate on bonds		3.06709%

Fair Value: As of June 30, 2006, in connection with all swap arrangements, the transactions had a total positive fair value of \$3,591. Because the coupons on the City's variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value decrease. The fair value was developed by a pricing service using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap.

Notes to the Financial Statements

**NOTE 4. LONG-TERM OBLIGATIONS
(CONTINUED)**

Credit risk: As of June 30, 2006, the City was exposed to credit risk in the amount of \$3,591 because the swap had a positive fair value. The swap counterparty, Bear Sterns was rated A by Standard & Poors. To mitigate the potential for credit risk, if the counterparty's credit quality falls below A-, the fair value of the swap will be collateralized by the counterparty with U.S. Government securities. Collateral would be posted with a third-party custodian.

Basis risk: As noted above, the swaps expose the City to basis risk should the relationship between LIBOR and the auction-rate converge, changing the synthetic rate on the bonds. If a change occurs that results in the rates' moving to convergence, the expected cost savings may not be realized.

Termination risk: The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Schedule to the Master Agreement includes an "additional termination event." That is, a swap may be terminated by the City if the counterparty's credit quality falls below "BBB-" as issued by Standard and Poor's. The City or the counterparty may terminate a swap if the other party fails to perform under the terms of the contract. If a swap is terminated, the variable-rate bond would no longer carry a synthetic interest rate. Also, if at the time of termination a swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.

Swap payments and associated debt: As of June 30, 2006, the debt service requirements of the variable-rate debt and net swap payments assuming current interest rates remain the same, for their term are summarized as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Fiscal Year Ending June 30,	Variable-Rate Bonds			
	Principal	Interest	Interest Rate Swaps, Net	Total
2007	\$ 400	\$ 1,741	\$ 121	\$ 2,262
2008	425	1,729	120	2,274
2009	425	1,717	119	2,261
2010	425	1,705	119	2,249
2011	450	1,692	118	2,260
2012-2016	4,275	8,101	563	12,939
2017-2021	8,625	7,232	503	16,360
2022-2026	13,550	5,472	380	19,402
2027-2031	15,175	3,390	235	18,800
2032-2036	17,375	1,062	74	18,511
Total	\$ 61,125	\$ 33,841	\$ 2,352	\$ 97,318

Notes to the Financial Statements

NOTE 5. RESTRICTED EQUITY

Pursuant to applicable bond indentures, a reserve for debt service has been established by restricting assets and reserving a portion of equity. Bond indentures for Riverside's water revenue bonds require reserves that equate to the maximum annual debt service required in future years plus three months interest and nine months principal due in the next fiscal year. The 2005 Refunding/Revenue bonds require 110% of the monthly accrued interest be included in the reserve. Additional reserves for the 1998 revenue bonds are not required due to the purchase of surety bonds to cover the reserve requirements.

NOTE 6. LITIGATION

The Water Utility is a defendant in various lawsuits arising in the normal course of business. Present lawsuits and other claims against the water utility are incidental to the ordinary course of operations of the Water Utility and are largely covered by the city's self-insurance program. In the opinion of management and the city attorney, such claims and litigation will not have a materially adverse effect upon the financial position or results of operation of the Water Utility.

The Water Utility is also a plaintiff in a lawsuit against the manufacturers and distributors of MTBE and its by-products, and of fuel containing these chemicals, arising out of the threat to the Water Utility wells of contamination with those chemicals from leaking underground storage tanks.

The defendants removed this lawsuit to federal court and then transferred the case to the Judicial Panel on Multidistrict Litigation, New York, where it was consolidated with all other pending MTBE water contamination litigation cases in the country. The consolidated cases are in the discovery phase, with no trial date set.

The City also detected perchlorate in a number of its drinking water wells. While Lockheed Martin has not admitted liability for the presence of perchlorate in the City's wells, Lockheed Martin has agreed to pay for the design, construction, installation, rental and permitting, and to reimburse the City for its operational and maintenance costs associated with perchlorate

treatment facilities on certain of the City's drinking water wells, under an agreement between the City and Lockheed Martin dated October 29, 2002 (the "Interim Perchlorate Agreement"). The Interim Perchlorate Agreement has been twice amended, on November 25, 2003 and on February 22, 2005, with each amendment increasing the number of wells from an original four wells to eleven wells now being treated for perchlorate at Lockheed Martin's expense.

NOTE 7. SPECIAL ITEM

In 1984 the City adopted a report by the Riverside Canal Abandonment Task Force, which outlined recommendations for abandoning those portions of the Riverside Canal that do not serve any agricultural water conveyance purposes. One critical component of the abandonment required significant construction of new storm drain facilities to transport water that would otherwise be carried in the Riverside Canal. During the fiscal year 2005, the required construction by the Water Utility was completed. The remaining portions of the storm drain will be constructed in conjunction with a development project planned adjacent to the Riverside canal, and upon completion, the Water Utility will then abandon its portions of the canal. These new facilities will be owned and operated by Riverside County Flood Control District. As a result, the Water Utility has recorded a charge against operations in the prior period of \$3,014, comprising \$1,147 in fiscal year 2005 and \$1,867 in fiscal year 2004 construction costs.

NOTE 8. CONSTRUCTION COMMITMENTS

As of June 30, 2006, the Water Utility had major commitments of approximately \$4,159 with respect to unfinished capital projects, of which \$3,211 is expected to be funded by bonds and \$948 funded by rates.

Key Historical Operating Data

WATER SUPPLY (ACRE FEET)

	2005/06	2004/05	2003/04	2002/03	2001/02
Pumping	76,605	73,732	81,797	70,977	79,937
Purchases	2,670	4,137	1,693	695	900
Total:	79,275	77,869	83,490	71,672	80,837
Percentage pumped	96.6%	94.7%	98.0%	99.0%	98.9%
System peak day (gallons)	118,782,000	112,094,000	105,029,000	101,484,000	102,241,000

WATER USE

Number of meters as of year end	2005/06	2004/05	2003/04	2002/03	2001/02
Residential	57,308	56,916	56,254	55,376	54,910
Commercial	5,204	5,114	4,932	4,782	4,776
Other	473	462	482	467	373
Total:	62,985	62,492	61,668	60,625	60,059
*CCF sales					
Residential	17,702,717	17,245,315	19,056,556	17,824,440	18,653,037
Commercial	9,822,196	9,252,639	9,988,578	9,411,391	9,820,471
Other	1,157,130	1,199,448	1,361,809	995,815	945,519
Wholesale	182,987	177,851	189,377	1,052,205	1,263,144
Total:	28,865,030	27,875,253	30,596,320	29,283,851	30,682,171

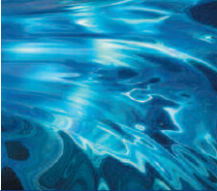
*(CCF equals 100 cubic feet)

WATER FACTS

	2005/06	2004/05	2003/04	2002/03	2001/02
Average annual CCF per residential customer	312	308	342	324	343
Average price (\$/CCF) per residential customer	\$ 1.26	\$ 1.16	\$ 1.05	\$ 1.01	\$.97
Debt service coverage ratio	5.11	2.85	3.52	2.60	3.89
Employees ¹	137	130	130	125	123

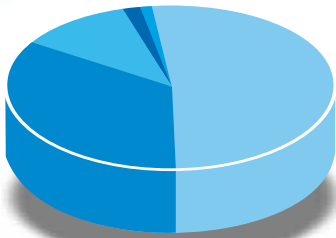
¹Approved positions

Key Historical Operating Data



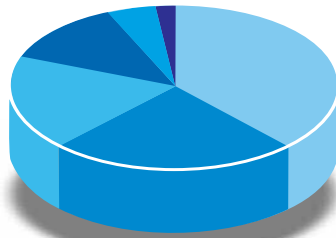
2005/06 WATER REVENUE AND RESOURCES

Source of Revenue



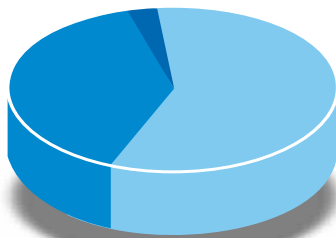
- Other Revenues (50¢)
- Residential Sales (31¢)
- Commercial (15¢)
- Other Sales (2¢)
- Investment Income (2¢)

Distribution of Revenue



- Operation & Maintenance (35¢)
- Additional Reserves (30¢)
- Additions & Replacements to the System (17¢)
- Debt Service (11¢)
- Transfers to the City's general fund* (5¢)
- Water Supply (2¢)

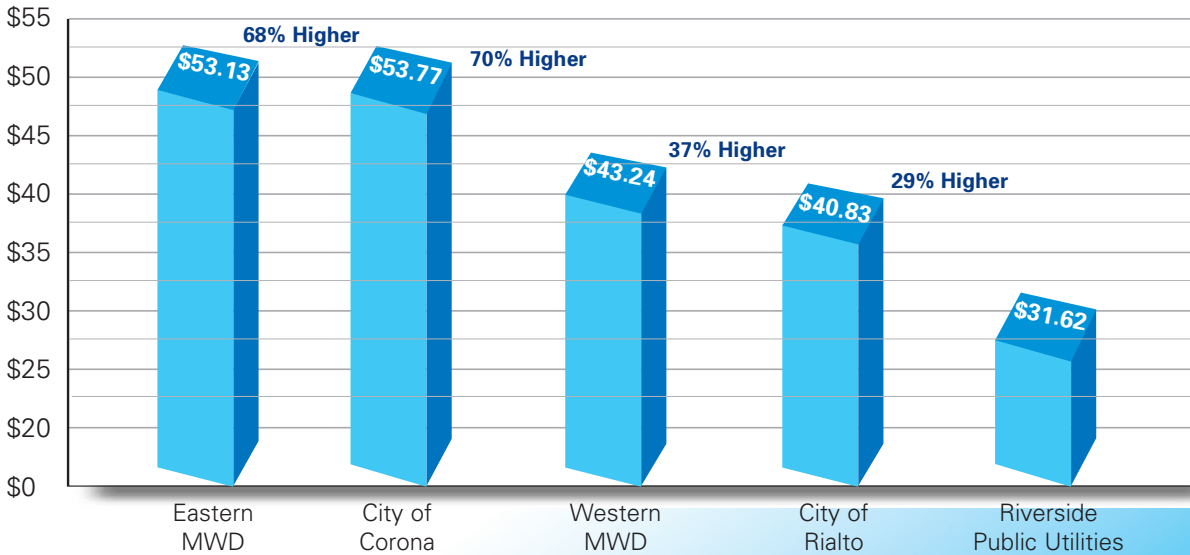
Water Resources



- San Bernardino Basin Wells (62%)
- Riverside Basin Wells (34.6%)
- Purchased Water (3.4%)

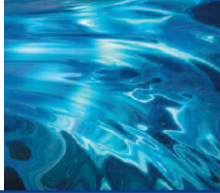
**Based on transfer of 11.5 percent of fiscal year 2004/05 revenues (excludes special item).*

Residential Water Rate Comparison
Monthly Usage of 27 CCF



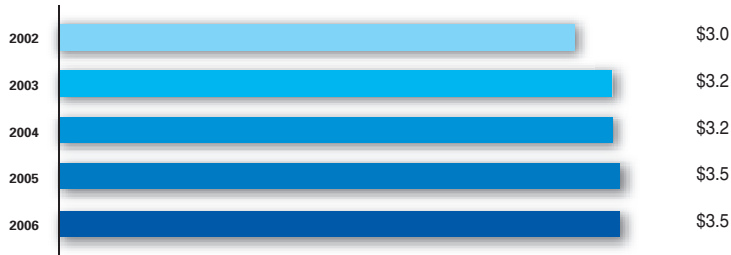
RATE COMPARISONS AS OF JUNE 1, 2006

WATER

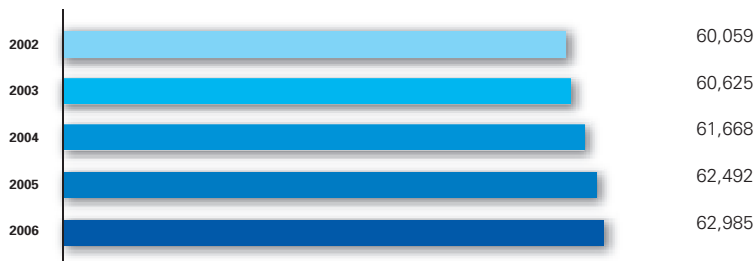


Key Historical Operating Data

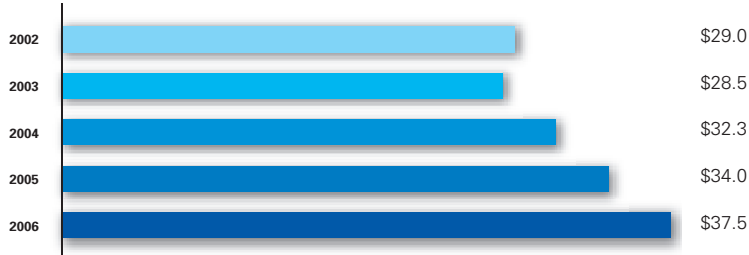
General Fund Transfer (in millions)



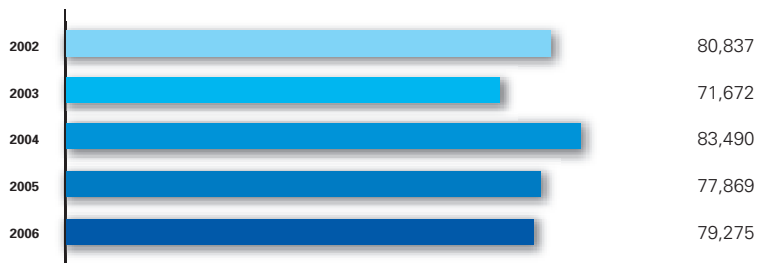
Number of Meters at Year End



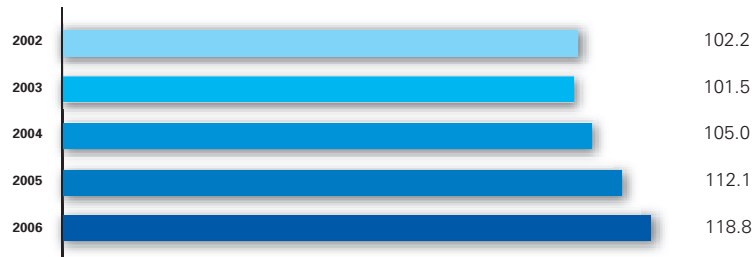
Total Operating Revenue (in millions)



Production (in acre feet)



Peak Day Demand (in million gallons)



Water Facts and System Data

Established:	1913
Service Area Population:	287,800
Service Area Size (square miles):	76.4
System Data:	
Smallest pipeline:	2.0"
Largest pipeline:	72.0"
Miles of pipeline:	967
Number of domestic wells:	51
Number of active reservoirs:	16
Total reservoir capacity (gallons):	100,400,000
Number of treatment plants:	10
Number of treatment vessels:	80
Miles of canal:	14
Number of fire hydrants:	7,127
Daily average production (gallons):	67,840,167
2005-06 Peak day (gallons):	118,782,000
8/9/05, 99 degrees	
Historical peak (gallons):	118,782,000
8/9/05, 99 degrees	

Bond Ratings

FITCH, INC.	AA
STANDARD & POOR'S	AA